

O.R.C. Chapter 1705—Ohio's New Statute on Limited Liability Companies

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I. INTRODUCTION

Interest in the limited liability company (LLC) languished and then flourished in accordance with its tax treatment.¹ When corporate tax rules applied, the LLC was the poor country cousin from Wyoming. However, once partnership tax rules were embraced,² the LLC was transformed into the Marlboro Man, ready to help American entrepreneurs keep plaintiffs' lawyers and tax collectors at bay, or at least limit the damage they could inflict on owners' pocketbooks. The LLC may well become the dominant form of business for nonpublic companies,³ particularly as nearly all fifty states have passed LLC statutes.⁴

¹ See generally Barbara C. Spudis, *Limited Liability Companies: An Introduction*, in LIMITED LIABILITY COMPANIES: FORMATION, OPERATION, AND CONVERSION 1, 10 (Robert W. Wood ed., 1993); BUS. L. TODAY, Mar./Apr. 1995 (devoting an entire issue to articles discussing LLCs); Robert R. Keatinge et al., *The Limited Liability Company: A Study of the Emerging Entity*, 47 BUS. LAW. 378 (1992); Wayne M. Gazur & Neil M. Goff, *Assessing the Limited Liability Company*, 41 CASE W. RES. L. REV. 387 (1991); Marybeth Bosko, Note, *The Best of Both Worlds: The Limited Liability Company*, 54 OHIO ST. L.J. 175 (1993). In addition to these academic materials, practitioners should be particularly interested in these sources: LARRY E. RIBSTEIN & ROBERT R. KEATINGE, RIBSTEIN AND KEATINGE ON LIMITED LIABILITY COMPANIES (1995); HARRY L. HENNING & RICHARD C. MCQUOWN, OHIO LIMITED LIABILITY COMPANY: FORMS AND PRACTICE MANUAL (1994).

² Rev. Rul. 88-76, 1988-2 C.B. 360 (This marked the first real instance of an LLC receiving partnership tax treatment by the I.R.S.; prior to this, LLC tax status as a partnership had been recognized only in a private letter ruling, which had no precedential effect. See Priv. Ltr. Rul. 81-06-082 (Nov. 18, 1980)).

³ Jeffrey A. Tannenbaum, *Enterprise*, WALL ST. J., July 17, 1992, at B1 (quoting Alan J. Wilensky, deputy assistant Treasury secretary for tax policy).

⁴ Hawaii, Massachusetts, and Vermont currently are the only states lacking the LLC as a possible choice of entity; the following are state LLC code sections: ALA. CODE §§ 10-12-1 to 10-12-61 (1994); ALASKA STAT. §§ 10.50.010 to 10.50.995 (1994) (effective July 1, 1995); ARIZ. REV. STAT. ANN. §§ 29-601 to 29-857 (Supp. 1992); ARK. CODE ANN. §§ 4-32-101 to 4-32-1316 (Michie 1994); 1994 Cal. Adv. Legis. Serv. 1200 (Deering); COLO. REV. STAT. §§ 7-80-101 to 7-80-1011 (1994); CONN. GEN. STAT. ANN. §§ 34-100 to 34-236 (1994); DEL. CODE ANN. tit. 6, §§ 18-101 to 18-1107 (Supp. 1993); FLA. STAT. ANN. §§ 608.401 to 608.514 (West 1993); GA. CODE ANN. §§ 14-11-100 to 14-11-1109 (Supp. 1995); IDAHO CODE §§ 53-601 to 53-672 (1994); ILL. REV. STAT. ch. 805, para. 180/1-1 to

The LLC has finally taken its place next to partnerships and corporations in the Ohio Revised Code,⁵ roughly seventeen years after Wyoming enacted the first LLC statute in the United States. As a business entity, the LLC is touted as combining the flow-through tax advantage of partnerships⁶ with the liability shelter of corporations.⁷ In other words, the LLC protects income from double taxation at the entity and membership levels. In the event of litigation, the LLC also protects its members' personal assets; their liability is limited to the amount of their investment in the LLC.

The LLC structure is a boon for many Ohio ventures and entrepreneurs. However, as with any innovation, it pays to temper enthusiasm for a new device with a decent understanding of its advantages and limitations.⁸ Several caveats are in order.

ch. 805, para. 180/60-1 (1994); IND. CODE §§ 23-18-1-1 to 23-18-13-1 (1994); IOWA CODE §§ 490A.100 to 490A.1601 (1993); KAN. STAT. ANN. §§ 17-7601 to 17-7651 (1992); KY. REV. STAT. ANN. §§ 275.001 to 275.455 (Michie/Bobbs-Merrill 1994); LA. REV. STAT. ANN. §§ 12:1301 to 12:1369 (West 1993); ME. REV. STAT. ANN. tit. 31, §§ 601 to 762 (West 1994); MD. CODE ANN., CORPS. & ASS'NS §§ 4A-101 to 4A-1102 (1993 & Supp. 1994); MICH. COMP. LAWS §§ 450.4101 to 450.5200 (1993 & Supp. 1994); MINN. STAT. ANN. §§ 322B.01 to 322B.955 (West Supp. 1993); MISS. CODE ANN. §§ 79-29-101 to 79-29-1204 (Supp. 1994); MO. REV. STAT. §§ 347.010 to 347.740 (Supp. 1995); MONT. CODE ANN. §§ 35-8-101 to 35-8-1307 (1994); NEB. REV. STAT. §§ 21-2601 to 21-2653 (1994); NEV. REV. STAT. ANN. §§ 86.011 to 86.571 (Michie 1994); N.H. REV. STAT. ANN. §§ 304-C:1 to 304-D:20 (1993); N.J. REV. STAT. §§ 42:2B-1 to 42:2B-70 (Supp. 1995); N.M. STAT. ANN. §§ 53-19-1 to 53-19-74 (Michie 1994); N.Y. LTD. LIAB. CO. LAW §§ 101 to 1043 (Consol. 1994); N.C. GEN. STAT. §§ 57C-1-02 to 57C-10-07 (1994); N.D. CENT. CODE §§ 10-32-01 to 10-32-155 (1993); OKLA. STAT. ANN. tit. 18, §§ 2000 to 2060 (West Supp. 1995); OR. REV. STAT. §§ 63.001 to 63.990 (1993); 1994 Pa. Laws 106; R.I. GEN. LAWS §§ 7-16-1 to 7-16-68 (1994); S.C. CODE ANN. §§ 33-43-101 to 33-43-1409 (Supp. 1994); S.D. CODIFIED LAWS ANN. §§ 47-34-1 to 47-34-59 (1994 & Supp. 1995); TENN. CODE ANN. §§ 48-201-101 to 48-248-606 (1994); TEX. REV. CIV. STAT. ANN. art. 1528n (West Supp. 1995); UTAH CODE ANN. §§ 48-2b-101 to 48-2b-158 (1994 & Supp. 1995); VA. CODE ANN. §§ 13.1-1000 to 13.1-1114 (Michie Supp. 1994); WASH. REV. CODE §§ 25.15.005 to 25.15.902 (1994); W. VA. CODE §§ 31-1A-1 to 31-1A-69 (Supp. 1995); WIS. STAT. §§ 183.0102 to 183.1305 (1993 & 1994 Supp.); WYO. STAT. §§ 17-15-101 to 17-15-136 (1977 & 1989 Supp.).

⁵ OHIO REV. CODE ANN. §§ 1705.01 to 1705.58 (Baldwin 1994) (effective July 1, 1994).

⁶ See *infra* notes 42-51 and accompanying text.

⁷ See *infra* notes 160-78 and accompanying text.

⁸ Jeffrey H. Reitzes, *Limited Liability Option Not for All Companies*, PLAIN DEALER, Dec. 6, 1994, at 3C (citing problems with conversion of existing corporations to LLC form, other tax consequences, newness and variety of the LLC among the various states, lender's

First, one should consult a tax specialist, during both the formation and operation of the LLC. This warning with respect to LLC formation is particularly applicable to Ohio's LLC statute, which is "flexible" as opposed to "bulletproof."⁹ This flexibility makes it possible for a practitioner inadvertently to outsmart himself and jettison a client's LLC flow-through tax treatment.¹⁰ With respect to LLC operation and reaping the full benefits under federal partnership tax law, one should keep in mind that partnership tax law is "distressingly complex and confusing [with] complex provisions [that] may confidently be dealt with by at most only a comparatively small number of specialists who have been initiated into its mysteries."¹¹ This Note will make brief reference to some of the finer points of federal partnership tax law beyond flow-through¹² and how they relate to the *operation* of a business. However, the federal tax law discussion will focus on LLC *formation* and the more fundamental question of initially securing partnership flow-through. This discussion will be geared toward developing an appreciation for Revenue Procedure 95-10 from the I.R.S.; such understanding is critical to applying the LLC in a practical and flexible manner to a variety of situations. These formational questions will focus on the rights the LLC members have with respect to transfer of their interests, management of the LLC, and dissolution of the LLC.

Second, the LLC has many of the same problems that exist with general and limited partnerships. To secure a partnership flow-through under federal tax law, the LLC must typically be subject to easy dissolution and a variety of restrictions on the transfer of entire membership interests. As a result, the LLC, in comparison to the C corporation, can be relatively limited with respect to its instability and difficulties in using equity financing.¹³

Third, the LLC is so new that LLC members must organize their affairs without the guidance of specialized case law. In particular, there is the matter of disregard of the fictional LLC entity in order to reach members' personal assets.¹⁴ This issue has as its counterpart the corporate law notion of "piercing the corporate veil." Questions of "disregard" or "piercing" the fictional entity

possible reluctance to loan without member's guaranty, and time and expense necessary to tailor an LLC operating agreement properly for a business).

⁹ See *infra* note 72 and accompanying text.

¹⁰ See *infra* notes 103-50 and accompanying text.

¹¹ Foxman v. Commissioner, 41 T.C. 535, 551 n.9 (1964); see also BORIS BITTKER, FEDERAL TAXATION OF INCOME, ESTATES AND GIFTS ¶ 85.11 (1981) (Subchapter K was a notable achievement only because "calamities are as 'worthy of note' as good news.").

¹² See *infra* notes 32-51 and accompanying text.

¹³ See *infra* notes 25-31 and accompanying text.

¹⁴ See *infra* notes 160-78 and accompanying text.

are critical. Unlike the corporation, the LLC may typically lack any sort of centralized management dividing ownership from control. Furthermore, unlike the limited partners in a limited partnership, whose limited liability is based on their lack of control, LLC members in general have both control and limited liability. This Note nonetheless advocates that corporate case law on disregard and piercing should be applied to similar disputes involving an LLC, although practitioners should understand that a different jurisprudence could develop on this issue.

With those caveats aside, Part II of this Note will discuss Ohio's LLC statute (hereinafter Chapter 1705) by beginning with the general advantages and disadvantages of the LLC as compared to other business structures, particularly the S corporation and the limited partnership. Part III then will look more closely at Chapter 1705 and its language with respect to formation, operation, reorganization, and termination or dissolution of an Ohio LLC. As mentioned previously, this section will also discuss relevant tax law necessary to secure a flow-through; the rights that members receive with respect to transfer of interests, management, and dissolution will determine how the I.R.S. taxes the business. Part IV will examine the limited liability feature of the LLC in the context of Ohio statutory law and case law on the LLC, the corporation, and the limited partnership. Finally, Part V will examine some structural, tax, and securities issues surrounding conversion of an existing partnership or corporation into an LLC.

II. GENERAL ADVANTAGES AND DISADVANTAGES OF LLCs

Before highlighting the strengths and weaknesses of the LLC as compared to other business entities, it is useful first to establish some idea of when one should consider using an LLC, which has potential for any business in which the owners want limited liability, flow-through tax treatment, and control over management.¹⁵ It is equally important to consider whether the owners are willing to live with the potential risks of easy dissolution and restrictions on transferability of interests.

Examples of enterprises that may benefit from LLC organization include: high technology research and development businesses; investments involving international partners; investment partnerships; start-up businesses; venture capital projects; family-owned businesses; commodity pools; joint ventures; professional firms; real estate or oil and gas ventures; holding companies; and environmental settlement funds.¹⁶ The LLC is well-suited to a number of these

¹⁵ Spudis, *supra* note 1, at 10.

¹⁶ *Id.* On the topic of foreign investment, see also Michael E. Hooton, *Structuring and Negotiating International Joint Ventures*, 27 CREIGHTON L. REV. 1013 (1994); David J.

pursuits conceived for a relatively limited duration or objective, such as research and development, investment partnerships, venture capital projects, joint ventures, real estate or oil and gas ventures, or environmental settlement funds. In these instances, continuity of the organization and free transferability of interests are not as significant, it may make good sense to trade them for the limited liability and tax pass-through of the LLC.

Before the LLC, businesses with foreign investors did not have the S corporation as an option.¹⁷ A limited partnership featuring a corporation as a general partner could offer both limited liability for all owners and tax pass-through, but this combination proved unwieldy. In contrast to this somewhat contorted solution, the LLC may have foreigners as members.¹⁸

In other instances, control may be extremely important to the business owners. For example, a small engineering firm composed of strong-willed and eccentric inventors may want limited liability without the bother of following corporate formalities in exercising their prerogatives. The matriarch in a closely-held business involving several generations and dozens of relatives or trusted employees may have similar interests, but the S corporation can have only one class of stock and thirty-five shareholders.¹⁹ In this instance, the LLC would allow many more people to hold an equity interest, but it could be structured so that not all interests would have voting power. Venture capitalists may appreciate the LLC because it allows them to exercise more control than limited partners in a limited partnership while still retaining partnership pass-through and limited liability.²⁰

The LLC also has been acclaimed as an estate planning tool.²¹ For example, the LLC can prevent a member's creditors from reaching the assets that the member has contributed to the LLC—the creditors are limited to a "charging order" on the debtor's share.²² With just a charging order, creditors

Thorpe, *Some Practical Points About Starting a Business in Singapore*, 27 CREIGHTON L. REV. 1039 (1994); Gary J. Dernelle, Note, *Direct Investment and Contractual Relations in the People's Republic of China*, 6 DEPAUL BUS. L.J. 331 (1994).

¹⁷ I.R.C. § 1361(b)(1)(C) (West 1995).

¹⁸ OHIO REV. CODE ANN. § 1705.04(A) (Baldwin 1994).

¹⁹ I.R.C. §§ 1361(b)(1)(A), (D) (West 1995).

²⁰ Kathleen K. Wright, *Comparing LLCs to S Corporations and Partnerships*, in LIMITED LIABILITY COMPANIES: FORMATION, OPERATION, AND CONVERSION 13, 49 (Robert W. Wood ed., 1993).

²¹ Richard M. Horwood, *Limited Liability Companies Provide New Planning Options*, ESTATE PLANNING, Sept./Oct. 1994, available in LEXIS, Estate Library; Armond D. Budish, *New Estate-Planning Tool Offers Corporate Benefits*, COLUMBUS DISPATCH, May 13, 1994, at 2F.

²² OHIO REV. CODE ANN. § 1705.19 (Baldwin 1994).

can receive only the cash or property that the LLC distributes to the member, and those distributions are discretionary.²³

To summarize this introduction to Part II, an I.R.S. official has stated that the LLC is mainly an alternative for businesses that could already use another form of flow-through entity, such as the S corporation or the limited partnership.²⁴ For the practitioner guiding a client through a choice-of-entity decision for his business, the LLC choice involves more than simply deciding that the business would benefit from a combination of limited liability and tax pass-through. One also must ask to what extent the business would suffer from the risk of easy dissolution and restrictions on transferability of interests.

A. *The LLC as Compared to the C Corporation*

The C corporation²⁵ under Ohio law²⁶ is worth mentioning briefly because there are situations where it is simply irreplaceable, and the LLC should not even be considered. Unlike the LLC, the C corporation is not hobbled by the risk of easy dissolution or restrictions on the transfer of interests in the organization; as a result, the C corporation can make public offerings of equity securities and raise capital through the sale of this stock. In addition to this significant financing option, shareholders also enjoy the benefit of a more fluid investment. Unfortunately, this continuity and marketability of interests comes at a price—the C corporation and its shareholders are double-taxed²⁷ compared to the LLC and its members.²⁸ There is another distinct drawback to the C

²³ *Id.* § 1705.11.

²⁴ *Use of Limited Liability Companies Seen Not Jeopardizing Corporate Tax Base*, DAILY REP. FOR EXECUTIVES, Mar. 30, 1993, at 59 (quoting Susan Pace Hamill, attorney advisor, office of the IRS chief counsel).

²⁵ I.R.C. §§ 301–385 (West 1995).

²⁶ OHIO REV. CODE ANN. §§ 1701.01–.99 (Baldwin 1994).

²⁷ I.R.C. § 11 (West 1995) (C corporation must pay income tax on its own income); *id.* § 61; *id.* § 301; *id.* § 316 (requiring shareholders to include any capital gains or dividends in their gross income).

²⁸ Because the LLC falls under partnership tax law, I.R.C. § 701 exempts the LLC itself from paying income taxes, and that liability passes through to the members. Partnership to partner, or LLC to member, distributions are typically tax-free as well. I.R.C. § 731 (West 1995). In addition, a partner can use partnership losses to offset income from other sources. *Id.* § 702. *But see id.* § 704(d) (owner can deduct business losses only to the extent of his basis in the partnership or LLC); *id.* § 465 (deduction of losses allowed only to the extent of the amount the owner has “at risk” in the partnership or LLC); *id.* § 469 (special restrictions applying to passive investors).

corporation that sets it apart from the LLC, or partnerships for that matter—getting a business out of the corporate form, once it is in it, will trigger taxes.²⁹

In conclusion, the C corporation is superior to the LLC for the operation of larger, publicly traded businesses—in fact, an LLC with publicly traded membership interests³⁰ or more than 500 members³¹ will likely be treated as a corporation for tax purposes and not a partnership. In other words, despite its combination of limited liability and pass-through tax status, there are instances in which the LLC cannot compete with the C corporation.

B. *The LLC as Compared to the S Corporation*

The LLC is typically compared to either the S corporation or the limited partnership,³² because only these three entities provide the unique combination of both limited liability and pass-through tax treatment. However, the LLC holds advantages over each of the other two entities. Compared to the S corporation, the LLC is not encumbered with the rigid restraints characteristic of the S corporation.

Like the C corporation, the “small business corporation,” or S corporation, is a creature of both state³³ and federal law.³⁴ Federal law, in addition to prescribing tax treatment, is also cumulative with state law in the context of an S corporation because it places additional restrictions on the corporate structure. For example, the S corporation cannot have more than thirty-five shareholders.³⁵ In contrast, the LLC must have at least two members,³⁶ although its maximum size may be limited as well by federal tax considerations.³⁷ In this respect, the S corporation, which can have just one owner, would be superior to the LLC when a client has no associates with whom she wishes to share ownership in a business.

²⁹ Laura Saunders, *S, C or Me?*, FORBES, Dec. 5, 1994, at 168, 170; see *infra* notes 183–87 and accompanying text.

³⁰ I.R.C. § 7704(b) (West 1995).

³¹ I.R.S. Notice 88-75, 1988-2 C.B. 386, 387.

³² See generally Wright, *supra* note 20, at 13–58; Joseph C. Vitek, *Tax Aspects of Limited Liability Companies*, 27 CREIGHTON L. REV. 191, 210–214 (1993); Susan Kalinka, *The Limited Liability Company and Subchapter S: Classification Issues Revisited*, 60 U. CIN. L. REV. 1083, 1103–28 (1992).

³³ OHIO REV. CODE ANN. §§ 1701.01–.99 (Baldwin 1994).

³⁴ I.R.C. §§ 1361–1378 (West 1995).

³⁵ *Id.* § 1361(b)(1)(A).

³⁶ OHIO REV. CODE ANN. § 1705.04 (Baldwin 1994).

³⁷ I.R.S. Notice 88-75, 1988-2 C.B. 386, 387.

Except for certain trusts and estates, the general rule is that partnerships, corporations, or foreign citizens may not hold stock in an S corporation.³⁸ However, the LLC may have as a member any natural person, general or limited partnership, trust, estate, association, LLC, corporation, or any other individual or entity in its own or representative capacity.³⁹ Finally, the S corporation may have only one class of stock.⁴⁰ Again, the LLC is much more flexible. As noted earlier, LLC membership interests may be assigned in their entirety or with just economic rights.⁴¹ This point has certain tax consequences as well, in that the S corporation must make pro rata distributions. The S corporation cannot make special allocations of gains or income in the way that the LLC can under Internal Revenue Code § 704(b).

In fact, while the S corporation shares the pass-through tax characteristic⁴² of a partnership, it falls under Subchapter S, and not under Subchapter K, the federal partnership tax code.⁴³ As mentioned earlier, this prevents the S corporation from making use of special allocations to distribute gains and losses. There are other partnership tax rules that the LLC may take advantage of as well.⁴⁴ As noted in Part I, a thorough discussion of these finer points of federal partnership tax law is beyond the scope of this Note.⁴⁵ Brief reference is made below to two of the more significant differences between Subchapter S and Subchapter K relating to basis adjustments.

Debt assumed by the LLC increases a member's basis. S corporation debt has no effect on a shareholder's basis unless the loan is made directly from the shareholder to the entity.⁴⁶ Under Internal Revenue Code § 705, a partner's basis equals the amount of his contributions, plus or minus any income or losses; Internal Revenue Code § 752(a) provides that a partner's assumption of additional partnership debt is a cash contribution to the partnership. An LLC member who personally guaranteed an LLC debt would be able to make use of Internal Revenue Code § 752(a) to include the amount of that debt in the basis of his membership interest. This is important because Internal Revenue Code §

³⁸ I.R.C. § 1361(b)(1)(B)-(C) (West 1995).

³⁹ OHIO REV. CODE ANN. §§ 1705.01(K), 1705.02 (Baldwin 1994).

⁴⁰ I.R.C. § 1361(b)(1)(D) (West 1995).

⁴¹ See *infra* notes 103-09 and accompanying text.

⁴² I.R.C. § 1366 (West 1995) (pass-through of the S corporation).

⁴³ The Internal Revenue Code deals separately with S corporations under Subchapter S, I.R.C. §§ 1361-1378; partnership tax provisions can be found under Subchapter K, I.R.C. §§ 701-761.

⁴⁴ Vitek, *supra* note 32, at 210-14; see also David C. Culpepper, *Tax Aspects of Limited Liability Companies*, 73 OR. L. REV. 5, 16-24 (1994) (discussing distinct issues raised by the application of partnership tax law to the LLC).

⁴⁵ See *supra* notes 11-12 and accompanying text.

⁴⁶ I.R.C. § 1366(d)(1)(B) (West 1995).

704(d) limits deduction of partnership losses by a partner to the amount of the partner's adjusted basis in his contribution.⁴⁷ If the LLC assumes nonrecourse debt for which no member is personally liable, the debt is shared by the LLC members based on their respective profit-sharing ratios.⁴⁸ Passive activity rules under Internal Revenue Code § 465 and § 469 would come into play in this instance, however, and limit deductible losses to the amount of money that a member actually has at risk in the LLC.

Falling under federal partnership tax law also allows the LLC member to take advantage of the Internal Revenue Code § 754 election.⁴⁹ This election allows LLC members to make a step-up in basis whenever the LLC makes a cash or property distribution⁵⁰ or an LLC membership interest is transferred.⁵¹ The election is advantageous to a transferee-partner if the partnership property has a net built-in gain; a positive adjustment will then increase the transferee-partner's special basis in partnership assets. The effect is to avoid taxing the transferee-partner on the appreciation of his proportionate share of partnership assets that occurred prior to his even buying into the partnership.

Compared to the S corporation, the LLC provides for a great deal more flexibility, particularly if plans involve international investors who are prohibited from owning stock in an S corporation. Apart from these structural differences, there are operational distinctions in the applicable tax law that favor the LLC over the S corporation.

C. The LLC as Compared to the General Partnership

Many of the crucial distinctions between the LLC and the two corporate forms are a matter of federal tax law, although there are also state law reasons, involving simplicity and reduced paperwork and protocol, for choosing the LLC over the corporation. In the context of deciding between the LLC or a partnership, the distinctions are based almost entirely in state law and the personal rights and liabilities associated with LLC membership or

⁴⁷ In addition to the I.R.C. § 704(d) limitation on a partner's deductible share of partnership losses, I.R.C. § 465(a) allows deduction of such losses only to the extent the taxpayer is at risk. Cash or property contributed is considered to be at risk, as are loans for which the partner (or LLC member) is personally liable. *Id.* § 465(b)(1)–(2).

⁴⁸ Treas. Reg. § 1.753-3 (1995).

⁴⁹ See Wright, *supra* note 20, at 32–34.

⁵⁰ I.R.C. §§ 754, 734 (West 1995).

⁵¹ *Id.*

partnership.⁵² Because limited partnerships must have at least one general partner,⁵³ a brief discussion of general partnerships is in order.

In the general partnership, each partner is jointly and severally liable to third persons for the wrongful acts of another partner acting in the ordinary course of business⁵⁴ and for a fellow partner's breach of trust.⁵⁵ Partners are jointly liable for the ordinary business debts of the partnership.⁵⁶ Creditors in proceedings in execution of a judgment against the partnership must first exhaust partnership property before they can reach the personal assets of a partner.⁵⁷ As for the LLC, its debts, obligations, and liabilities are solely those of the LLC; neither the member nor the managers of the LLC are personally responsible for them. However, this distinction involving owner liability has been blurred recently; the same legislation that enacted the Ohio LLC also changed Ohio partnership law and created a "registered partnership having limited liability."⁵⁸

Apart from the critical distinction involving personal liability, the general partnership and the LLC share much in common. The members of each have broad agency and management authority.⁵⁹ In addition, both groups have the right to request and receive true and full information regarding the affairs and financial status of their business,⁶⁰ although the LLC may keep trade secrets confidential from its members and withhold other information.⁶¹

⁵² OHIO REV. CODE ANN. §§ 1775.05, .14, .17, .33, .35, .39, .61-.63 (Baldwin 1994).

The key addition is § 1775.61.

⁵³ See *infra* notes 62-66 and accompanying text.

⁵⁴ OHIO REV. CODE ANN. § 1775.12 (Baldwin 1994).

⁵⁵ *Id.* § 1775.13.

⁵⁶ *Id.* § 1775.14(B).

⁵⁷ *Id.*; *Wayne Smith Constr. Co. v. Wolman, Duberstein & Thompson*, 604 N.E.2d 157, 163 (Ohio 1992).

⁵⁸ See *infra* notes 160-78 and accompanying text.

⁵⁹ OHIO REV. CODE ANN. § 1775.08(A) (Baldwin 1994) (every partner is an agent of the partnership for the purpose of conducting its business); *id.* § 1775.17(E) (subject to any agreement between them, all partners have equal rights in the management and conduct of the business); *id.* § 1705.24 (LLC management authority vested in members in proportion to their capital contributions unless provided otherwise in a written operating agreement); *id.* § 1705.25 (every LLC member is an agent of the company for the purpose of its business).

⁶⁰ *Id.* § 1775.18 (partners have access to books); *id.* § 1775.19 (partners may demand and receive any information about the partnership); *id.* § 1705.22(A) (subject to any reasonable standards in the operating agreement or otherwise established by the members, each member has the right to obtain information about the LLC).

⁶¹ *Id.* § 1705.22(B):

D. *The LLC as Compared to the Limited Partnership*

A limited partnership is a partnership formed by two or more persons under the laws of Ohio, having as members one or more general partners and one or more limited partners.⁶² The LLC provides limited liability for all its members,⁶³ while the limited partnership requires that at least one of its partners be personally liable for all its debts and obligations.⁶⁴ Furthermore, limited partners may not “participate in control of the business.”⁶⁵ If the limited partner’s participation in the management or day-to-day operation of the business is not substantially the same as that of the general partner, he then is liable only to persons who transact business with the limited partnership with actual knowledge of his participation in control.⁶⁶

As mentioned earlier, the S corporation and the limited partnership pose the main competition for the LLC. Apart from the fact that LLC law is so new, and therefore somewhat untested and unsettled, it seems to overwhelm the other two entities. In fact, the limited partnership now would appear to be obsolete. In contrast to the limited partnership, the LLC provides limited liability for all members under state law, while at the same time allowing LLC members to take full advantage of federal partnership tax law.

III. CHAPTER 1705—OHIO’S LLC STATUTE

If one decides to organize an Ohio LLC, it is important to always keep in mind the Treasury Regulations that make it possible for the LLC to enjoy partnership tax treatment under Subchapter K. The I.R.S. does not

(B) Unless otherwise provided in the operating agreement, a limited liability company has the right to keep confidential from its members for a reasonable period of time any information that the company reasonably considers to be in the nature of trade secrets or any other information as follows:

(1) Information the disclosure of which the company in good faith reasonably believes is not in the best interest of the company or could damage the company or its business;

(2) Information that the company is required by law or by agreement with a third person to keep confidential.

⁶² *Id.* § 1782.01(H).

⁶³ See *infra* notes 160–78 and accompanying text.

⁶⁴ See generally Kalinka, *supra* note 32, at 1114–21.

⁶⁵ OHIO REV. CODE ANN. § 1782.19 (Baldwin 1994).

⁶⁶ *Id.*

automatically treat an LLC as a partnership.⁶⁷ To secure partnership tax treatment, it is critical that the LLC have no more than one of the following three characteristics: "continuity of life," "centralization of management," and "free transferability of interests."⁶⁸

The I.R.S. adopted Treasury Regulation § 301.7701-2, the so-called *Kinter* regulations, in response to a Dr. Kinter who had sought corporate status for his medical practice in the 1950s. By doing so, he then could take advantage of exempt retirement plans available to employees, but not to partners in a partnership.⁶⁹ Written without any contemplation of the LLC, the regulations are weighted in favor of classifying unincorporated entities as partnerships.⁷⁰ The regulations list six characteristics of corporations: (1) associates; (2) an objective to carry on business and divide the gains therefrom; (3) continuity of life; (4) centralization of management; (5) liability for corporate debts limited to corporate property; and (6) free transferability of interests.⁷¹

Under Treasury Regulation § 301.7701-2(3), any organization will be classified as a corporation if it has more corporate characteristics than noncorporate characteristics. However, characteristics common to both forms are excluded from this analysis. Ties of characteristics are decided in favor of finding a partnership. Because the regulation is written in terms of corporations versus partnerships, rather than LLCs, only the characteristics of associates and business for profit are necessarily shared. Of the four remaining characteristics, the LLC automatically has limited liability. Thus, any particular LLC may have no more than one of the following: continuity of life, centralization of management, and free transferability of interests.

Unlike "bulletproof" LLC statutes that make it impossible to form an LLC that does not qualify for partnership tax treatment, Ohio has a "flexible" statute.⁷² Bulletproof statutes guarantee federal partnership tax treatment by

⁶⁷ For those who would like an I.R.S. determination with regard to their LLCs, the IRS has recently released Rev. Proc. 95-10, 1995-3 I.R.B. 20, which specifies when it will consider a ruling request relating to LLC classification for federal tax purposes; this revenue procedure also provides concise explanations relating to particular corporate characteristics.

⁶⁸ Treas. Reg. § 301.7701-2(a)(1) (1995); see, e.g., *Larson v. Commissioner*, 66 T.C. 159 (1976).

⁶⁹ Francis T. Wirtz & Kenneth L. Harris, *Tax Classification of the Limited Liability Company*, in *LIMITED LIABILITY COMPANIES: FORMATION, OPERATION, AND CONVERSION* 107, 112 (Robert W. Wood ed., 1993).

⁷⁰ *Id.*

⁷¹ Treas. Reg. § 301.7701-2(a); see also *Morrissey v. Commissioner*, 296 U.S. 344 (1935) (cited as the basis for the regulation's language and criteria).

⁷² James J. Wheaton, *Forming the Limited Liability Company*, in *LIMITED LIABILITY COMPANIES: FORMATION, OPERATION, AND CONVERSION* 59, 86 (Robert W. Wood ed., 1993). The I.R.S. has ruled LLCs formed under the four bulletproof statutes would be

requiring the consent of all members to continue the LLC after dissolution or to allow an assignee to assume full membership, hence destroying the characteristics of continuity of life and free transferability of interests. Chapter 1705 is flexible in that it provides default provisions that assure an LLC will be treated as a partnership for federal tax purposes. However, because those default provisions are not mandatory, an LLC may be tailored to suit a particular client. Combined with this flexibility is the threat that a practitioner inadvertently may give an LLC two of the three characteristics of continuity, centralized management, and free transferability.

To clarify the relationship between any state and federal tax law, the I.R.S. issued Revenue Procedure 95-10.⁷³ Revenue Procedure 95-10 provides guidance and safe harbors that will enable an LLC to possess greater continuity of life, transferability of interests, and centralized management without losing the benefits of partnership tax treatment.⁷⁴ Now that this context has been established, Part III will discuss provisions of Chapter 1705 in conjunction with federal law on partnership taxation.

A. Formation of an Ohio LLC

Two or more persons, without regard to residency, domicile, or state of organization may form an LLC in Ohio by filing "articles of organization" with the Secretary of State⁷⁵ and paying an eighty-five dollar fee.⁷⁶ The presence of two or more persons is believed to be necessary to secure partnership tax treatment, and all LLC statutes except for Texas' require two persons.⁷⁷ The articles of organization must set forth the name for the company, the address to

classified as partnerships for tax purposes. See Rev. Rul. 93-6, 1993-3 I.R.B. 8 (Colorado); Rev. Rul. 93-30, 1993 C.B. 231 (Nevada); Rev. Rul. 93-5, 1993-3 I.R.B. 6 (Virginia); Rev. Rul. 93-50, 1993-2 C.B. 310 (West Virginia). The I.R.S. has also ruled that LLCs formed under 12 flexible statutes can be treated as partnerships. See Rev. Rul. 94-6, 1994-1 C.B. 314 (Alabama); Rev. Rul. 93-93, 1993-2 C.B. 321 (Arizona); Rev. Rul. 94-79, 1994-2 C.B. 409 (Connecticut); Rev. Rul. 93-38, 1993 C.B. 38 (Delaware); Rev. Rul. 93-53, 1993-2 C.B. 312 (Florida); Rev. Rul. 93-49, 1993-2 C.B. 308 (Illinois); Rev. Rul. 94-30, 1994-1 C.B. 316 (Kansas); Rev. Rul. 94-5, 1994-1 C.B. 312 (Louisiana); Rev. Rul. 94-51, 1994-2 C.B. 407 (New Jersey); Rev. Rul. 93-92, 1993-2 C.B. 318 (Oklahoma); Rev. Rul. 93-81, 1993-2 C.B. 314 (Rhode Island); Rev. Rul. 93-91, 1993-2 C.B. 316 (Utah).

⁷³ Rev. Proc. 95-10, 1995-3 I.R.B. 20.

⁷⁴ John D. Cunningham, *The Tax Angle: New IRS Guidelines Shine a Brighter Light on LLCs*, BUS. L. TODAY, Mar./Apr. 1995, at 21.

⁷⁵ OHIO REV. CODE ANN. § 1705.04(A) (Baldwin 1994).

⁷⁶ *Id.* § 111.16(F).

⁷⁷ Wheaton, *supra* note 72, at 60-61 (referring to Tex. Rev. Civ. Stat. Ann. art. 1528n, art. 1.02(A)(3), art. 3.01, art. 3.02 (West 1995)).

contact for copies of any operating agreement or bylaws, the LLC's period of duration, and any other provision consistent with the law that the members choose to list.⁷⁸ The name of the LLC must be distinguishable from that of any other LLC or corporation registered with the Secretary of State. The name must also include one of the following: "Limited Liability Company"; "Limited"; "LTD."; or "LTD".⁷⁹

With respect to period of duration, there is an unfortunate inconsistency with the default provisions controlling this element. In one instance, the duration of the LLC is to be "perpetual", unless the articles of organization state otherwise.⁸⁰ In a later section, the period of duration seems to become thirty years from the date of the formation of the company, unless stated otherwise.⁸¹ While the term of existence is not as crucial to the element of continuity of life as it may appear,⁸² the General Assembly needs to pass a corrective amendment.

Although the statute does not require the LLC to have a written operating agreement, it often refers to such a document. The drafting and adoption of such an agreement is a wise choice. Nonetheless, an operating agreement may be oral,⁸³ and Chapter 1705 will provide default provisions in certain instances where there is no written agreement. Unlike the articles of organization, an operating agreement, oral or otherwise, is not required by law to be a matter of public record, although interested persons may request copies of the document from the LLC.⁸⁴

The LLC may be used in Ohio for any purpose or purposes for which individuals associate, although restrictions apply to professionals. First, attorneys may not use the LLC for their practices, although the Ohio Supreme Court is reconsidering this problem.⁸⁵ Law firm use of the LLC has been

⁷⁸ OHIO REV. CODE ANN. § 1705.04(A) (Baldwin 1994).

⁷⁹ *Id.* § 1705.05(A).

⁸⁰ *Id.* § 1705.04(B).

⁸¹ *Id.* § 1705.43(A)(1).

⁸² See *infra* notes 103-09 and accompanying text.

⁸³ OHIO REV. CODE ANN. § 1705.01(I) (Baldwin 1994).

⁸⁴ *Id.* § 1705.04(A)(4) (allowing members the election to set out provisions of the operating agreement in the articles of organization); *id.* § 1705.04(A)(3) (requiring that the articles of organization list the address to which interested persons may direct requests for copies of any bylaws or operating agreement).

⁸⁵ *Ohio Rules for Government of the Bar, Rule III (A)(2)*, in RULES GOVERNING THE COURTS OF OHIO (1994). The Ohio Supreme Court is considering amendments to Rule III that would allow attorneys to practice through an LLC. However, even under these amendments, equity holders would still face vicarious liability, in the form of joint and several liability for claims against the firm, and personal liability for his own acts or omissions. Proposed Amendments to Rules for the Government of the Bar of Ohio

thwarted in no small part because there are ethical concerns surrounding the issue of limited liability. For example, when a client hires an attorney, he has the right to expect the fidelity of not just that attorney, but the other members of the firm as well.⁸⁶ In response to these concerns, one can argue that notions of vicarious liability are out of step in an age of large law firms where hundreds of lawyers are segregated into different practice areas.⁸⁷ Proponents of this view argue that competition for clients and the ever-increasing costs of malpractice insurance are safeguards that effectively promote high quality legal work.⁸⁸

Second, there is some confusion regarding the use of the LLC by physicians. However, state law relating to accountants,⁸⁹ architects,⁹⁰ dentists,⁹¹ pharmacists,⁹² and professional engineers and surveyors⁹³ was amended specifically to allow the use of the LLC by these professionals. While the LLC will not insulate the professional from his own malpractice, it will protect him from vicarious liability for the acts or omissions of a co-member.⁹⁴

Chapter 1705 also requires appointment of a statutory agent for service of process⁹⁵ and provides for the amendment of the articles of organization.⁹⁶ Once formed, the Ohio LLC has full authority to deal in any interest in property, contract, sue and be sued, form other business associations, indemnify its directors, officers, and employees, and otherwise conduct itself as would any person or corporation.⁹⁷

(regarding changes to Gov. Bar R. III, Legal Professional Associations Authorized to Practice Law, and Gov. Bar R. VI, Registration of Attorneys) (available from the Ohio Supreme Court).

⁸⁶ Stephen C. Crane, *An Ethical Lawyer's Guide to LLC Firms*, N.Y. L.J., Nov. 7, 1994, at 1; see also Debra L. Thill, Comment, *The Inherent Powers Doctrine and Regulation of the Practice of Law: Will Minnesota Attorneys Practicing in Professional Corporations or Limited Liability Companies Be Denied the Benefit of Statutory Liability Shields?*, 20 WM. MITCHELL L. REV. 1143 (1994).

⁸⁷ Richard C. Reuben, *Added Protection*, A.B.A. J., Sept. 1994, at 54, 56.

⁸⁸ *Id.*

⁸⁹ OHIO REV. CODE ANN. § 4701.14(F) (Baldwin 1994).

⁹⁰ *Id.* §§ 4703.18, 4703.331.

⁹¹ *Id.* § 4715.18.

⁹² *Id.* § 4729.02(H)(4).

⁹³ *Id.* § 4733.16.

⁹⁴ Wheaton, *supra* note 72, at 69.

⁹⁵ OHIO REV. CODE ANN. § 1705.06 (Baldwin 1994).

⁹⁶ *Id.* § 1705.08.

⁹⁷ Compare *id.* § 1705.03 (LLC authority to conduct business) and § 1705.32 (LLC authority to indemnify managers, directors, trustees, officers, employees, and agents) with § 1701.13 (corporate authority, including authority to indemnify directors, officers, employees, and agents).

One final question remains regarding formation of the LLC: When does the LLC come into existence and protect its members with limited liability? The articles of organization are filed with the Secretary of State's office, which then checks to see if they comply with Chapter 1705 before it endorses them.⁹⁸ However, the Secretary of State's duties are ministerial; his office makes no legal determinations if the articles appear on their face to be sufficient.⁹⁹ Administrative delays or delays over possible technical defects may push back the legal formation of the LLC, which would expose initial members or managers to the same sort of liability as that of general partners or corporate organizers in pre-corporate transactions.¹⁰⁰ In addition, mistakes involving transfer of interests, management, or dissolution could have federal tax implications as well that could destroy the LLC's pass-through. One solution provides that a defective filing of articles of organization may be cured within twenty days after the organizer has been given notice. If the defect is cured, the LLC is deemed to have been formed when the articles were first delivered for filing.¹⁰¹ Ohio's southern neighbor, Kentucky, has this feature in its LLC statute.¹⁰² Ohio's Chapter 1705 does not appear to make this solution available, so extra care should be taken on this point. The General Assembly should consider adopting a statute similar to Kentucky's.

B. *O.R.C. §§ 1705.15, 1705.43, and Continuity of Life*

The identity and relationship of the members, and not the term of duration, should be the focus when determining whether an LLC has the corporate characteristic of continuity of life. The issue is whether the LLC is so closely connected with its members that a change in their identity will effect a change in

⁹⁸ *Id.* § 1705.07(A).

⁹⁹ *Id.* § 1705.07(B).

¹⁰⁰ Wheaton, *supra* note 72, at 62.

¹⁰¹ *Id.* (citing §§ 205(B), 206(A) of the Prototype Limited Liability Company Act (Report of Nov. 19, 1992) published by the Working Group on the Prototype Limited Liability Company Act of the Subcommittee on Limited Liability Companies of the Committee on Partnerships and Unincorporated Business Organizations of the Section of Business Law of the American Bar Association).

¹⁰² KY. REV. STAT. ANN. § 275.065 (Michie/Bobbs-Merrill Supp. 1994) (providing that "articles of correction" shall be effective on the effective date of the document they correct, except as to persons relying on the uncorrected document.); *see also* ARK. CODE ANN. § 4-32-1309 (Michie Supp. 1994); CONN. GEN. STAT. ANN. § 33-611 (West Supp. 1995); GA. CODE ANN. § 14-11-211 (1994); IND. CODE ANN. § 23-18-12-5 (West 1994); IOWA CODE § 490A.123 (1993); N.C. GEN. STAT. § 57C-1-24 (1993); OR. REV. STAT. § 63.014 (1994).

the identity of the LLC.¹⁰³ LLC membership terminates if a member resigns or the other members remove or expel him according to the operating agreement.¹⁰⁴ Membership will also cease if a member makes an assignment for the benefit of creditors, files a voluntary petition for bankruptcy, or is adjudicated bankrupt or insolvent. Corporate or partnership membership terminated with the dissolution of either of those business associations.¹⁰⁵ A member of an LLC may also terminate his membership by assigning his interest.¹⁰⁶

The dissolution of the LLC may occur upon a fixed date or a particular event, such as the departure of one member, the unanimous written agreement of all members to dissolve the LLC, the membership decreasing to less than two members, or upon entry of a decree of judicial dissolution.¹⁰⁷ Each

¹⁰³ Wirtz & Harris, *supra* note 69, at 113.

¹⁰⁴ OHIO REV. CODE ANN. § 1705.15 (Baldwin 1994):

Except as approved by the specific written consent of all members at the time, a person ceases to be a member of a limited liability company upon the occurrence of any of the following events of withdrawal:

(A) A member resigns or withdraws as a member in accordance with the operating agreement or under section 1705.16 or 1705.18 of the Revised Code.

(B) A member is removed or expelled as a member in accordance with the operating agreement.

(C) Unless otherwise provided in writing in the operating agreement, the member does any of the following:

(1) Makes an assignment for the benefit of creditors;

(2) Files a voluntary petition in bankruptcy;

(3) Is adjudicated a bankrupt or insolvent;

(4) Files a petition or answer in any reorganization, arrangement, composition, readjustment, liquidation, dissolution, or similar relief proceeding under any law or rule that seeks for himself any of those types of relief;

(5) Files an answer or other pleading admitting or failing to contest the material allegations of a petition filed against him in any proceeding seeking the relief described in division (C)(4) of this section.

¹⁰⁵ *Id.*

¹⁰⁶ *Id.* § 1705.18.

¹⁰⁷ *Id.* § 1705.43:

(A) A limited liability company organized under this chapter shall be dissolved upon the occurrence of any of the following events:

(1) The expiration of the period fixed by the operating agreement for the duration of the company or, if an expiration period is not fixed by the operating agreement, thirty years from the date of the formation of the company;

member may apply for judicial dissolution, which the court may decree if it can be shown that it is no longer reasonably practicable to carry on the business of the company.¹⁰⁸

If one is drafting the articles of organization of an LLC and needs to avoid the continuity of life characteristic, one cannot simply limit the existence of the LLC to a set period of time or the completion of a specific enterprise.¹⁰⁹ Instead, one should rely either on specific events that will terminate a membership and possibly dissolve the LLC, or on simply granting each member the unilateral right to dissolve the LLC. Following the default provisions under Chapter 1705 will result in an LLC lacking continuity of life.

Under Treasury Regulation § 301.7701-2(b)(1):

[I]f the death, insanity, bankruptcy, retirement, resignation, expulsion or other event of withdrawal of a general partner of a limited partnership causes a dissolution of the partnership, continuity of life does not exist; furthermore, continuity of life does not exist notwithstanding the fact that a dissolution of the limited partnership may be avoided, upon such an event of withdrawal of a general partner, by the remaining general partners agreeing to continue the partnership or by at least a majority in interest of the remaining partners agreeing to continue the partnership.¹¹⁰

Treasury Regulation § 301.7701-2(b)(2) goes on to state that dissolution is “an alteration in the identity of an organization by reason of a change in the relationship between members as determined under *local law*.”¹¹¹ As an

(2) One or more events specified in writing in the operating agreement as causing the dissolution of the company;

(3) The unanimous written agreement of all members to dissolve the company;

(4) The withdrawal of a member of the company, unless the business of the company is continued by the consent of all of the remaining members or under a right to continue the company that is stated in writing in the operating agreement;

(5) At any time when there are less than two members;

(6) Upon entry of a decree of judicial dissolution under section 1705.47 of the Revised Code.

(B) Following the occurrence of any of the events specified in division (A) of this section, the limited liability company shall deliver to the secretary of state for filing a certificate of dissolution on a form that is prescribed by the secretary of state and that includes the name of the company and the effective date of its dissolution.

¹⁰⁸ *Id.* § 1705.47.

¹⁰⁹ Wirtz & Harris, *supra* note 69, at 115.

¹¹⁰ Treas. Reg. § 301.7701-2(b)(1) (as amended in 1993).

¹¹¹ *Id.* § 301.7701-2(b)(2) (emphasis added).

example of change in relationship, the regulation gives the destruction of a mutual agency relationship. In other words, automatic dissolution upon some event affecting a member will destroy continuity. However, having a procedure in place for continuing operation after that event falls short of continuity of life, in that it is less like continuity and more like a having a contingency plan that provides the option of continuity.

Treasury Regulation § 301.7701-2(b)(3) continues by stating that the at-will authority of any one LLC member to dissolve the entity will eliminate continuity of life.¹¹² If the articles of organization state that the LLC is to continue for a stated period or until the completion of a stated transaction, then continuity does exist, under the theory that at-will dissolution has been suspended. However, in an exception, Treasury Regulation § 301.7701-2(b)(3) will overlook the terms between the members of the LLC if the local statute provides for at-will dissolution; in other words, at-will dissolution exists even if the exercise of such power by the member would result in a violation of the articles of organization or the operating agreement.

As an adjunct to Treasury Regulation § 301.7701-2(b)(3), Revenue Procedure 95-10 provides additional flexibility and assurances. As stated earlier, the LLC operating agreement could reject the statutory default provisions and still avoid an I.R.S. finding that the organization possesses continuity of life. Chapter 1705's default provisions state that the withdrawal of an LLC member will result in dissolution, unless the remaining members unanimously agree to continue.¹¹³ Revenue Procedure 95-10 allows that a majority in interest of the remaining members may vote to continue the business,¹¹⁴ and that the number of dissolution events can be limited, so long as such limits still "provide a meaningful possibility of dissolution."¹¹⁵ In short, an operating agreement can make it more difficult to dissolve the LLC, while simultaneously making it simpler to continue the LLC, and this increased stability can be had without triggering a finding of continuity of life by the I.R.S. When appropriate, members may want to limit each other's right to withdrawal,¹¹⁶ or the effects related to such events as a member's bankruptcy, incompetency, or death.¹¹⁷

In short, the question of whether a Chapter 1705 Ohio LLC exists perpetually¹¹⁸ or for a period of thirty years¹¹⁹ is not important in deciding

¹¹² *Id.* § 301.7701-2(b)(3).

¹¹³ *Id.* § 1705.16(A).

¹¹⁴ Rev. Proc. 95-10, § 5.01(1), (2), 1995-3 I.R.B. 20.

¹¹⁵ *Id.* § 5.01(4).

¹¹⁶ OHIO REV. CODE ANN. § 1705.16(A) (Baldwin 1994).

¹¹⁷ *Id.* § 1705.15.

¹¹⁸ *Id.* § 1705.04(A)(2).

whether continuity of life is present. Instead, Chapter 1705 provides default provisions that should prevent the finding of continuity of life. Section 1705.15 provides for termination in the event of a member's bankruptcy, insolvency, or other incompetency. Sections 1705.15(A) and 1705.43(A)(4) provide for withdrawal of an LLC member and voluntary dissolution. Where voluntary withdrawal would violate any agreements between members, section 1705.47 provides that any LLC member may unilaterally seek judicial dissolution.

For practical purposes, businesses want to avoid the uncertainty of such strategic behavior as hold-ups and threats of dissolution by recalcitrant members. To that end, Chapter 1705 does provide the practical flexibility to tailor articles of organization and operating agreements according to Revenue Procedure 95-10, while still providing the default provisions necessary under Treasury Regulation § 301.7701-2(b)(1). So long as at least a majority of members must consent to continuation of the business after dissolution, an LLC should lack continuity of life.

C. O.R.C. §§ 1705.24, 1705.29 and Centralization of Management

Chapter 1705 reserves management authority of the LLC to the members,¹²⁰ but they are free to select members or to hire non-members to serve as managers. This option provides unlimited structuring opportunities, to the extent that an LLC management structure can mirror a formal corporate structure.¹²¹ The presumption under Chapter 1705 is that all members are managers, although a group of members or outsiders may be chosen to serve as management. With that said, an LLC following the statutory norm will lack centralization, but the use of managers will probably constitute centralization.

Under Treasury Regulation § 301.7701-2(c):

An organization has centralized management if any person (or any group of persons which does not include all members) has continuing exclusive authority to make the management decisions Centralized management means a *concentration of continuing exclusive authority* to make independent

¹¹⁹ *Id.* § 1705.43(A)(1).

¹²⁰ *Id.* § 1705.24:

Unless otherwise provided in writing in the operating agreement, the management of a limited liability company shall be vested in its members in proportion to their contributions to the capital of the company, as adjusted from time to time to properly reflect any additional contributions or withdrawals by the members.

¹²¹ Wheaton, *supra* note 72, at 76-77.

business decisions . . . which *do not require ratification by members of such organization.*¹²²

Rather than being de facto, the centralization of management must be accomplished through some formal election to office, proxy appointment, or similar means.¹²³

Chapter 1705 contains default provisions which do not provide for centralized management,¹²⁴ but which also provide no protection if set aside in the interests of using managers. Unlike the characteristic of continuity of life, Treasury Regulations will not apply these LLC management default provisions if the operating agreement or articles of organization provide for any sort of centralized management.

In Revenue Ruling 88-76, the Wyoming LLC was found to have centralized management because only three out of twenty-five members were managers,¹²⁵ but in one bizarre instance, the I.R.S. said that a Colorado LLC in which all the members were also managers had centralized management.¹²⁶ As its rationale, the I.R.S. emphasized that Colorado law required LLC management by managers, not members; even though all members of this LLC served as managers, their management authority did not arise out of their status as members. In a private letter ruling, another LLC was deemed to lack centralized management when management was exercised according to ownership in the LLC.¹²⁷ Ownership can also be significant in another way. Under Revenue Procedure 89-12,¹²⁸ the I.R.S. stated that for limited partnerships, management of the partnership by persons holding twenty percent or less of the ownership amounts to centralized management. Subjecting member-managers to periodic election, or giving non-managing members substantially non-restricted power to remove the member-managers will not prevent the I.R.S. from finding the characteristic of centralized management.¹²⁹

¹²² Treas. Reg. § 301.7701-2(c) (as amended in 1993) (emphasis added).

¹²³ *Id.* § 301.7701-2(c)(2).

¹²⁴ OHIO REV. CODE ANN. §§ 1705.24, .29 (Baldwin 1994) (section 1705.29 provides in part that “[i]f the operating agreement of a limited liability company provides for managers, then the business of the company shall be exercised by or under the direction of its managers, except to the extent applicable law or the operating agreement provides otherwise.”).

¹²⁵ 1988-2 C.B. 360.

¹²⁶ Rev. Rul. 93-6, 1993-1 C.B. 229.

¹²⁷ Priv. Ltr. Rul. 90-10-026 (Dec. 7, 1989).

¹²⁸ 1989-1 C.B. 798.

¹²⁹ Rev. Proc. 95-10, 1995-3 I.R.B. 20.

Revenue Procedure 95-10 echoes this. In part, it states that the I.R.S. may rule that an LLC with managers lacks centralized management, so long as those managers own at least twenty percent of the total interest.¹³⁰ However, the I.R.S. reserves the right to "consider all relevant facts and circumstances, including, particularly, member control of the member-managers."¹³¹ Significantly, Revenue Procedure 95-10 states that subjecting the member-managers to periodic elections or the threat of a "substantially non-restricted power to remove" by other members is not alone sufficient to prevent a finding of centralized management.¹³² In conclusion, centralized management is best avoided by providing for management by equity members acting in their capacity as members, rather than managers.

If the members choose to exercise management authority, then their authority parallels a general partner's authority. With respect to certain exceptions, such as confession of judgment against the LLC, each LLC member may act as an agent of the LLC.¹³³ Management and voting authority seem somewhat split. The statute apportions management authority according to a member's contribution to the LLC, whereas voting rights may be apportioned on a per capita basis, per class, or any other basis with votes being taken only as dictated by the operating agreement.¹³⁴ In other words, as alluded to before, the LLC may be as hierarchical or egalitarian as its members desire.

The LLC manager has a duty of good faith; he must act in a manner he reasonably believes to be in, or not opposed to, the best interests of the company.¹³⁵ Conflicts of interest between members or managers and the LLC may be resolved through disclosure and subsequent ratification of the particular contract or transaction by disinterested members or managers.¹³⁶

D. *O.R.C. §§ 1705.18, 1705.20, and Free Transferability of Interests*

A person may become a member of the LLC at its formation, upon the consent of all other LLC members, or by receiving an assignment of membership from an authorized member.¹³⁷ If the assignee does not receive a

¹³⁰ *Id.* § 5.03(2).

¹³¹ *Id.*

¹³² *Id.*

¹³³ OHIO REV. CODE ANN. § 1705.25 (Baldwin 1994).

¹³⁴ *Id.* § 1705.26.

¹³⁵ *Id.* § 1705.29(B); see also Sandra K. Miller, *What Standards of Conduct Should Apply to Members and Managers of Limited Liability Companies?*, 68 ST. JOHN'S L. REV. 21 (1994).

¹³⁶ OHIO REV. CODE ANN. § 1705.31 (Baldwin 1994).

¹³⁷ See *id.* § 1705.18:

full membership, he will hold a partial interest that entitles him to allocations and distributions from the LLC.¹³⁸

Under Ohio Revised Code section 1705.18, LLC membership is assignable in whole or in part, but that assignment does not always entitle the assignee to exercise the rights of a member. The section distinguishes between an economic interest in the LLC and a controlling or voting interest. Ohio Revised Code section 1705.20 further states that an assignee may become a member under one of two conditions: either the assignor has the authority under the operating

Except as otherwise provided in the operating agreement, a membership interest in a limited liability company is assignable in whole or in part. An assignment of a membership interest does not dissolve the company or entitle the assignee to become or to exercise any rights of a member. An assignment entitles the assignee to receive, to the extent assigned, the distributions of cash and other property and the allocations of profits, losses, income, gains, deductions, credits, or similar items to which his assignor would have been entitled. Except as otherwise provided in the operating agreement, an assignor remains a member and retains those rights the assignee is not entitled to receive. Unless otherwise provided in an operating agreement and except to the extent assumed by agreement, until an assignee of a membership interest becomes a member, the assignee does not have liability as a member solely because of the assignment.

Id.; see also *id.* § 1705.20:

(A) An assignee of a membership interest in a limited liability company may become a member if and to the extent that the assignor gives the assignee that right and either of the following occurs:

(1) The assignor has been given the authority in writing in the operating agreement to give an assignee the right to become a member.

(2) All other members consent.

(B) An assignee who has become a member has to the extent assigned the rights and powers of a member under the operating agreement and this chapter and is subject to the restrictions and liabilities of a member under the operating agreement and this chapter. An assignee who becomes a member also is liable for the obligations of his assignor to make contributions as provided in section 1705.09 of the Revised Code. An assignee is not obligated for liabilities that could not be ascertained from a written operating agreement and that were unknown to the assignee at the time he became a member.

(C) An assignor is not released from his liability to a limited liability company under section 1705.09 of the Revised Code whether or not the assignee becomes a member.

Id.

¹³⁸ *Id.* § 1705.18.

agreement to give the assignee the rights of membership, and the assignor does so, or all members consent to the new membership.

Treasury Regulation § 301.7701-2(e)(1) states that free transferability does not exist in a case in which each member can, without the consent of the other members, assign only his right to share in profits, but not his right to participate in the management of the organization. In the context of partnership law applied to LLCs, free transferability may be destroyed by requiring consent from a manager or less than a unanimous group of members. In addition, free transferability may be destroyed by restricting more than twenty percent of the interests in the entity, which would allow the remainder of interests to be freely traded.

In the context of a limited partnership, the requirement that general partners approve a transfer of interests by the limited partners causes the partnership to lack free transferability.¹³⁹ As applied to LLCs, the I.R.S. has issued private letter rulings indicating that the same holds true if the LLC manager must approve a member's transfer of his whole interest and management authority to an assignee.¹⁴⁰ However, this particular approach has its risks, namely, that the manager must be more than a member-controlled puppet who exercises only rubber-stamp approval.¹⁴¹

Unanimity of the members is not required to prevent a finding of free transferability, so long as at least a majority of the members must approve the new member.¹⁴² Furthermore, it seems that free transferability does not exist if the substitution of members takes place by reason of the death, dissolution, divorce, liquidation, merger, or termination of the transferor member, and the transferee was a either a relative or an affiliate.¹⁴³

Finally, with respect to destroying free transferability by restricting "substantially all of the interests in organization," the I.R.S. has stated in Revenue Procedure 92-33 that:

Generally, the Service will rule that a partnership lacks free transferability of interests if, throughout the life of the partnership, the partnership agreement expressly restricts (within the meaning of section 301.7701-2(e)(1) of the regulations) the transferability of partnership interests representing more than

¹³⁹ Treas. Reg. § 301.7701-3(b)(2)(Ex. 1).

¹⁴⁰ Priv. Ltr. Rul. 92-10-018 (Dec. 6, 1991).

¹⁴¹ Rev. Rul. 77-214, 1977-1 C.B. 408; Rev. Rul. 93-4, 1993-3 I.R.B. 5 (holding that when an entity is controlled by a "single economic interest" it may have the characteristic of free transferability).

¹⁴² Rev. Rul. 93-91, 1993-41, I.R.B. 22; Priv. Ltr. Rul. 93-08-027 (Nov. 27, 1992); Priv. Ltr. Rul. 92-10-019 (Dec. 6, 1991).

¹⁴³ Priv. Ltr. Rul. 92-10-019 (Dec. 6, 1991).

20 percent of all interests in partnership capital, income, gain, loss, deduction, and credit.¹⁴⁴

Transfers subject to at least majority approval are not freely transferable, and those subject to unanimous approval, as required under section 1705.20(A)(2), are not freely transferable in the eyes of the I.R.S. Additional options are available to increase transferability. An LLC can take advantage of Revenue Procedure 95-10 to increase transferability without triggering a finding of free transferability so long as more than twenty percent of all interests in the LLC cannot be transferred without majority approval.¹⁴⁵ In other words, if the full attributes of control and economic benefit can be transferred without majority approval in the case of seventy-nine percent of an LLC's shares, the I.R.S. will not find free transferability because of the restrictions imposed on the remaining twenty-one percent. Furthermore, Revenue Procedure 95-10 allows an LLC define majority interest in terms of capital or profits or per capita basis.¹⁴⁶

Members may contribute cash, property, services rendered, promissory notes, or any other binding obligations to make some such contribution,¹⁴⁷ but the obligation must be in writing that is enforceable against a member.¹⁴⁸ Profits, losses, income, gains, deductions, credits, and similar items are divided among members or classes of members according to the operating agreement. If the operating agreement does not provide for such allocations, the allocations are made based on the member's contribution to the LLC.¹⁴⁹ Cash distributions are made in a similar manner.¹⁵⁰

E. Merger and Consolidation

The Ohio LLC and one or more other entities, foreign or domestic, may be merged into either another LLC¹⁵¹ or some other entity.¹⁵² Written notice must be given in advance of any meeting to approve a merger or consolidation,¹⁵³ and managers and members have the power and authority to approve or

¹⁴⁴ 1992-1 C.B. 782.

¹⁴⁵ Rev. Proc. 95-10, § 5.02(1), (2), 1995-3 I.R.B. 20.

¹⁴⁶ *Id.* § 5.02(3).

¹⁴⁷ OHIO REV. CODE ANN. § 1705.09 (Baldwin 1994).

¹⁴⁸ *Id.* § 1705.09(B).

¹⁴⁹ *Id.* § 1705.10.

¹⁵⁰ *Id.* § 1705.11.

¹⁵¹ *Id.* § 1705.36.

¹⁵² *Id.* § 1705.37.

¹⁵³ *Id.* § 1705.36(E).

disapprove any amalgamation.¹⁵⁴ Dissenting members of the LLC¹⁵⁵ are entitled to seek relief in the form of damages equal to the fair cash value of their membership interests.¹⁵⁶ If adopted, a certificate of merger must be filed with the Secretary of State.¹⁵⁷

The chief advantage of Ohio's "cross-species" merger statute is that it should make it more likely that an existing partnership can be converted into an LLC without a conveyance of assets that would trigger sales tax, use tax, and other transfer taxes.¹⁵⁸ Still, before attempting such a merger or consolidation, one should consider the implications for existing contracts, loan agreements, title insurance, or other agreements to which the existing entity or its assets are subject.¹⁵⁹

IV. LIMITED LIABILITY OF THE LLC MEMBER

One of the LLC's key advantages is that it provides limited liability to its members and management¹⁶⁰ for the debts and obligations of the LLC; these

¹⁵⁴ *Id.* §§ 1705.36(D), .37(D).

¹⁵⁵ *Id.* § 1705.40.

¹⁵⁶ *Id.* § 1705.41.

¹⁵⁷ *Id.* § 1705.38.

¹⁵⁸ Paul L. Lion III & Gerald G. Chacon, Jr., *Converting Partnerships and Corporations to Limited Liability Companies: Legal, Tax, and Practical Considerations*, in LIMITED LIABILITY COMPANIES: FORMATION, OPERATION, AND CONVERSION 165, 198 (Robert W. Wood ed., 1993).

¹⁵⁹ Linda A. Striefsky, *An Introduction to the Ohio Limited Liability Company Statute*, REAL PROPERTY NEWS (Real Property Section of the Ohio State Bar Association, Columbus, Ohio), Summer 1994, at 1, 19. For a discussion on LLCs and lenders, see Harry L. Henning & Richard C. McQuown, *A Primer for Lenders: Getting Beyond Confusion When an LLC Needs a Loan*, BUS. L. TODAY, Mar./Apr. 1995, at 25.

¹⁶⁰ OHIO REV. CODE ANN. § 1705.48 (Baldwin 1994):

(A) The debts, obligations, and liabilities of a limited liability company, whether arising in contract, tort, or otherwise, are solely the debts, obligations, and liabilities of the limited liability company.

(B) Neither the members of the limited liability company nor any managers of the limited liability company are personally liable to satisfy any judgment, decree, or order of a court for, or are personally liable to satisfy in any other manner, a debt, obligation, or liability of the company solely by reason of being a member or manager of the limited liability company.

(C) Nothing in this chapter affects any personal liability of a member of a limited liability company or any manager of a limited liability company for the member's or manager's own actions or omissions.

individuals are personally liable for only their own acts. However, uncertainty remains as to how courts will interpret this statute. With the passage of LLC statutes in so many states,¹⁶¹ concerns over interstate liability of LLC members¹⁶² seem less relevant. This does not resolve concerns of intrastate member liability surrounding the possible disregard or piercing of the LLC fictional entity.¹⁶³ Part IV examines limited liability in the context of limited partnerships and corporations in Ohio in order to gain a better understanding of the protection afforded LLC members under Ohio Revised Code section 1705.48.

Ohio law has taken the approach that the partnership is an aggregate of individuals,¹⁶⁴ as opposed to the corporation¹⁶⁵ or the LLC,¹⁶⁶ both of which are defined as an "entity." However, as we have already seen, the LLC is more like a partnership than a corporation in many respects, which suggests that the veil of an LLC may not be quite as sturdy as a corporation's. The significance of the distinction rests in the fact that a limited partner's liability protection is based on his lack of control.¹⁶⁷ For example, in *Hommel v. Micco*,¹⁶⁸ the limited partners had released their supervisor on a condominium project, at which point they assumed day-to-day management over the construction. This management included direct contact with their electrical contractor,¹⁶⁹ who eventually sued for payment. The court held that the limited partners' "final 'say so'" on all major decisions and their personal approval of most of the limited partnership's contracts¹⁷⁰ rendered them general partners.

(D) This chapter does not affect any statutory or common law of this or another state that pertains to the relationship between an individual who renders a professional service and a recipient of that service, including, but not limited to, any contract or tort liability arising out of acts or omissions committed or omitted during the course of rendering the professional service.

¹⁶¹ See *supra* note 4.

¹⁶² Keatinge et al., *supra* note 1, at 447-56.

¹⁶³ See generally *id.* at 443-46 (discussing intrastate LLC transactions).

¹⁶⁴ OHIO REV. CODE ANN. § 1775.05(A) (Baldwin 1994); see also *Arpadi v. First MSP Corp.*, 628 N.E.2d 1335, 1338 (Ohio 1994); *Fairway Dev. Co. v. Title Ins. Co. of Minnesota*, 621 F. Supp. 120, 122 (N.D. Ohio 1985).

¹⁶⁵ Keatinge et al., *supra* note 1, at 443; see *infra* text accompanying note 171.

¹⁶⁶ OHIO REV. CODE ANN. § 1705.01(D)(2)(e) (Baldwin 1994).

¹⁶⁷ *Id.* § 1782.19.

¹⁶⁸ 602 N.E.2d 1259 (Ohio 1991).

¹⁶⁹ *Id.* at 1260.

¹⁷⁰ *Id.* at 1262.

The corporate shareholder's liability protection is based on the idea of a fictional entity that has a separate will and existence apart from its owners,¹⁷¹ although shareholders may be reached through the common law theory of "piercing the corporate veil."¹⁷² Again, the element of control plays a role, and total control of the entity by its owners can result in disregard of the fiction. The Ohio Supreme Court sees the theory of piercing the veil as having developed in equity to protect creditors from corporate shareholders who use the corporate veil as a cloak to commit fraud or crimes.¹⁷³ It has held that the corporate form may be disregarded and individual shareholders held liable for corporate misdeeds when (1) control over the corporation by those to be held liable was so complete that the corporation has no separate mind, will, or existence of its own, (2) control over the corporation by those to be held liable was exercised in such a manner as to commit fraud or an illegal act against the person seeking to disregard the corporate entity, and (3) injury or unjust loss resulted to the plaintiff from such control and wrong.¹⁷⁴ In its first application of this test, the Ohio Supreme Court reversed the appellate court on the basis that there was less than total shareholder control.

Corporate limited liability would seem to provide the LLC members with good protection, but it is uncertain that such protection extends to the new entity. The Ohio Constitution deals specifically with corporate shareholders under Article XIII, Section 3, which provides in part that "[d]ues from private corporations shall be secured by such means as may be prescribed by law, but in no case shall any stockholder be individually liable otherwise than for the unpaid stock owned by him or her." The Ohio Supreme Court has refused to extend this protection to Licensed Professional Associations (LPAs).¹⁷⁵ The court first drew a distinction between private corporations and professional associations. It then justified that distinction on the basis that LPA shareholders, unlike shareholders in a private corporation, are also employed by the business and are directly involved in and control its management.¹⁷⁶ This owner-manager parallel between an LPA and LLC is somewhat disconcerting.

¹⁷¹ Keatinge et al., *supra* note 1, at 443.

¹⁷² *Id.* at 443-44.

¹⁷³ *Belvedere Condominium Unit Owners' Ass'n v. R.E. Roark Cos.*, 617 N.E.2d 1075, 1085 (Ohio 1993).

¹⁷⁴ *Id.* at 1086 (adopting test developed in *Bucyrus-Erie Co. v. Gen. Products Corp.*, 643 F.2d 413 (6th Cir. 1981)).

¹⁷⁵ *South High Dev., Ltd. v. Weiner, Lippe & Crowley Co.*, 445 N.E.2d 1106, 1108-10 (Ohio 1993), *limited*, *KMS Energy v. Titmas*, 610 N.E.2d 1080, 1081 (Ohio 1992) (holding that *South High* applies only to attorney liability as a member of a legal professional association).

¹⁷⁶ *Id.*

Fortunately, another parallel may be drawn between the LLC and the close corporation,¹⁷⁷ where shareholders may be intimately involved with day-to-day affairs and yet are still protected by limited liability.

While the General Assembly appears to have intended that the LLC benefit from corporate liability rules by defining the LLC as an "entity," the hybrid nature of the LLC and the extent of the member's control makes the scope of the LLC limited liability indefinite. To complete Ohio's LLC statute, the state legislature should adopt legislation similar to other states', which require courts to apply corporate limited liability case law to LLCs.¹⁷⁸

V. CONVERSIONS

Individuals already operating in either a partnership or corporation may be interested in converting to an LLC. The following discussion explores some of the major issues involved in such conversions.

A. Partnership to LLC

Under I.R.C. § 741, the general rule is that the sale or exchange of a partnership interest will trigger the recognition of a gain or loss by the transferor partner. However, an I.R.S. revenue ruling provides an exception to this rule. Revenue Ruling 84-52 involved the conversion of a general partnership to a limited partnership. The I.R.S. stated that while the conversion was an "exchange," Internal Revenue Code § 721 applied. as a result, no gain or loss is recognized by a partnership or its partners where there is a contribution of property to the partnership in exchange for a partnership interest. Several private letter rulings have supported the application of this

¹⁷⁷ See Keatinge et al., *supra* note 1, at 395-96, 446. Ohio's close corporation statute is OHIO REV. CODE ANN. § 1701.591; the bulk of the annotations to that section deal mainly with the duties that close corporation shareholders owe each other. See Crosby v. Beam, 548 N.E.2d 217 (Ohio 1989) (holding that majority shareholders have a heightened fiduciary duty to minority shareholders that is similar to the duty partners owe one another).

¹⁷⁸ See, e.g., COLO. REV. STAT. § 7-80-107 (1990) The Colorado statute states:

In any case in which a party seeks to hold the members of a limited liability company personally responsible for the alleged improper actions of the limited liability company, the court shall apply the case law which interprets the conditions and circumstances under which the corporate veil of a corporation may be pierced under Colorado law.

Id. See also MINN. STAT. § 322B.303 (1994); N.D. CENT. CODE § 10-32-29 (1995).

reasoning to partnership-to-LLC conversions.¹⁷⁹ Because Chapter 1705 provides for cross-species mergers between different sorts of entities,¹⁸⁰ such a conversion should be relatively straightforward.

Some exceptions to this exception exist, however. One must also consider the effects of a partner's share of the partnership's liabilities compared to a member's share of the LLC's liabilities after conversion, because an LLC member is not generally liable for the debts of the organization. Under Internal Revenue Code § 752(b), any decrease in a partner's share of liabilities is a distribution of partnership money to the partnership, along with a corresponding decrease in the partner's basis under Internal Revenue Code § 733. If the decrease in liabilities exceeds the basis of the partnership interest, then the partner must recognize the excess as a gain. To avoid this effect upon conversion to an LLC, partners may wish to ensure that they remain liable on certain partnership debts even after the conversion.

For example, many limited partnerships are structured with a corporation as general partner. This structure, particularly if Ohio's close corporation statute¹⁸¹ is combined with Subchapter S requirements for pass-through tax treatment, comes very close to providing many of the unique advantages of the LLC. If one decides to convert to an LLC and dissolve the corporate general partner, problems similar to those discussed below will trigger an income tax on any realized gains. As with many transactions, it is wise to consult a tax specialist.¹⁸²

B. Corporation to LLC

Unlike partnership conversions, conversion of a corporation to an LLC will likely be taxed; the conversion will be seen as a liquidation of the corporation that will trigger the double-tax recognition of capital gains or losses¹⁸³ by both the corporation¹⁸⁴ and the shareholders.¹⁸⁵ Conversion of an S corporation will

¹⁷⁹ Priv. Ltr. Ruls. 95-01-033 (Oct. 5, 1994); 94-52-024 (Sept. 29, 1994); 92-26-035 (Mar. 26, 1992); 91-19-029 (Feb. 7, 1991); 92-10-019 (Dec. 6, 1990); 90-10-027 (Dec. 7, 1989).

¹⁸⁰ OHIO REV. CODE ANN. §§ 1705.36, .37 (Baldwin 1994).

¹⁸¹ *Id.* § 1701.591.

¹⁸² See generally Mark Golding, *Tax Aspects of Converting a Partnership or Corporation into an Oregon Limited Liability Company*, 73 OR. L. REV. 25, 27-36 (1994) (discussing conversion of a general or limited partnership into an LLC).

¹⁸³ I.R.C. §§ 331, 1001 (West 1995); see also Golding, *supra* note 182, at 37-42. Golding does explore two methods of essentially tax-free corporate-to-LLC conversion, but because of the likelihood of I.R.S. challenges, he advises that they are not for the "faint of heart." *Id.*

¹⁸⁴ I.R.C. § 336 (West 1995).

have the same effects but without a double tax. The resulting contribution to the LLC will be tax free.¹⁸⁶

In short, the conversion of a corporation to an LLC can have grievous federal income tax consequences. Because of this, such conversions are ill-advised. Exceptions to this rule of thumb are limited primarily to: (1) S corporations without built-in gain and with little or no appreciated assets; (2) S corporations with shareholders whose tax basis in their stock exceeds the value of the assets distributed, resulting in capital loss sufficient to offset gain, if any, from the deemed distribution; and (3) C corporations with sufficient net operating losses to offset any gain recognized under Internal Revenue Code § 336 on the deemed liquidation, and either (a) the fair market value of the C corporation's assets do not exceed the shareholder's tax basis in the shares, or (b) the shareholders have capital loss carryforwards to offset the gain recognized from the deemed distribution under Internal Revenue Code § 331.¹⁸⁷

C. LLC to Corporation

The founders of a new business enterprise may desire the advantages of an LLC for the early years of their company's growth, combined with the option of someday seeking additional capital through either venture capitalists or a public stock offering. While an LLC may not serve the business well at this later stage, it can be converted to a corporate form that will.

Under the Internal Revenue Code, no gain or loss is recognized if property is transferred to a corporation by one or more persons solely in exchange for stock in such corporation, and immediately after the exchange such persons control at least eighty percent of the total number of shares of stock.¹⁸⁸ As noted earlier, Chapter 1705 provides for cross-species mergers between business organizations, so such a conversion under Ohio law should parallel an Internal Revenue Code § 368(a)(1)(A) statutory merger. If so, Internal Revenue Code § 354(a)(1) provides that no gain or loss shall be recognized if stock or securities of a corporation involved in a reorganization are exchanged solely for stock or securities in another corporation which is a party to the reorganization.

¹⁸⁵ *Id.* § 331.

¹⁸⁶ *Id.* § 721.

¹⁸⁷ Lion & Chacon, *supra* note 158, at 171.

¹⁸⁸ I.R.C. §§ 351, 368(c) (West 1995).

D. Other Conversion Issues Involving State and Federal Securities Laws

1. Ohio Securities Law

Under Ohio law, an LLC membership interest is a "security."¹⁸⁹ As a result, the registration and exemption provisions of Ohio's "Blue Sky" laws apply. In general, anyone seeking to sell securities in Ohio must apply to the Ohio Division of Securities and provide the names and addresses of directors, officers, and trustees of the issuing company. In the case of an LLC, similar information must be provided for any members or managers.¹⁹⁰ The application must also provide the address of the issuer's principal place of business,¹⁹¹ the purpose and general character of the business,¹⁹² and up-to-date financial information on the business, including a balance sheet and income statements, copies of all circulars, prospectuses, and advertisements.¹⁹³ However, the sale of certain LLC memberships is exempt from this requirement if the sale is to no more than thirty-five members, and the sale meets other requirements suitable for smaller organizations.¹⁹⁴ Another statute, applicable when there are ten or few members involved, is even more streamlined.¹⁹⁵

2. Federal Securities Law

For most legitimate businesses, federal securities regulations will have no effect. However, the Securities Exchange Commission has started to prosecute "wireless cable" LLCs that it has charged with using "false and misleading statements" in nationwide promotions to sell memberships.¹⁹⁶

To be a "security" under federal law, an LLC membership would have to fall under some rubric such as "stock" or "investment contract" under the Securities Act of 1933.¹⁹⁷ The United States Supreme Court has provided a test

¹⁸⁹ OHIO REV. CODE ANN. § 1707.01(B) (Baldwin Supp. 1995).

¹⁹⁰ *Id.* § 1707.09(A) (Baldwin 1994).

¹⁹¹ *Id.* § 1707.09(B).

¹⁹² *Id.* § 1707.09(C).

¹⁹³ *Id.* §§ 1707.09(D), (E).

¹⁹⁴ *Id.* § 1707.06(A)(3) (Baldwin Supp. 1995).

¹⁹⁵ *Id.* § 1707.03(O) (Baldwin 1994).

¹⁹⁶ *SEC v. Parkersburg Wireless Ltd. Liab. Co.*, No. 94-1079, 1994 U.S. Dist. LEXIS 15006 (D.C. Oct. 19, 1994) (ordering that LLC placed into receivership, enjoining defendant Michelle Gerstner from further marketing membership interests in the LLC, and ordering her to disgorge \$537,637.64); *SEC Sues Companies, Individuals Promoting Wireless-Cable Units*, WALL ST. J., May 17, 1994, at A6; John R. Emshwiller, *SEC Sets Sights on Certain Limited Liability Companies*, WALL ST. J., Mar. 31, 1994, at B2.

¹⁹⁷ 15 U.S.C. §§ 77a, 77aa (1994).

for determining whether the LLC membership is a security. In *SEC v. W.J. Howe Co.*,¹⁹⁸ the Court held that “investment contract” means “a contract, transaction or scheme whereby a person invests his money in a common enterprise and is led to expect profits solely from the efforts of the promoter or a third party.” In other words, if the members intend to participate in the management and operation of the LLC, their interests are probably not securities under federal law. The difficult questions arise when the LLC has certain passive members or a centralized management, and members retain substantial veto powers.¹⁹⁹ Even if the LLC membership is a security, however, it may still be possible to exempt it from SEC registration.²⁰⁰

VI. CONCLUSION

The Ohio LLC under Chapter 1705 is a great advance over other business associations, but it has its limitations. Nonetheless, it will likely become the entity of choice for both new and established businesses. For those businesses that choose to convert to an LLC, the statute provides flexible, “cross-species” merger provisions between different sorts of entities, which should simplify tax planning. Overall, the LLC’s unique combination of flexibility, limited liability, and pass-through tax treatment should provide a welcome boost to entrepreneurial vigor in Ohio.

¹⁹⁸ 328 U.S. 293, 298–99 (1946); *see also* Carol R. Goforth, *Why Limited Liability Company Membership Interests Should Not Be Treated as Securities and Possible Steps to Encourage this Result*, 45 HASTINGS L.J. 1223 (1994).

¹⁹⁹ Lion & Chacon, *supra* note 158, at 176.

²⁰⁰ 15 U.S.C. § 77d (1994).

